Fishing Industry Advisory Board

Fishery Report

INCORPORATION

AND THE

NEWFOUNDLAND INSHORE FISHERMAN

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Prepared for the Fishing Industry Advisory Board

by

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FOREWORD

It is being suggested with increasing frequency, that it would be advantageous for fishermen to incorporate their business. There is no doubt that some fishermen would benefit from incorporation. It is doubtful, however, that this applies to all fishermen.

In order to obtain an accurate and complete picture of the pros and cons of incorporation of fishermen, the Fishing Industry Advisory Board asked Mr. George Cummins, Barrister and Solicitor, Memorial University, St. John's, Newfoundland to carry out an in-depth review of all applicable material and this report contains his findings.

During his career, Mr. Cummins has worked with the Canadian Transport Commission, the Department of Consumer and Corporate Affairs, the Foreign Investment Review Agency and the Royal Commission on Corporate Concentration. He is presently an Associate Professor at MUN, teaching Law. Tax and Finance. He has a Bachelor of Commerce from Acadia University, a Master of Business Administration from the University of Alberta, and a Bachelor of Law Degree from the University of British Columbia. Mr. Cummins is a member of the Bar of Ontario and of Newfoundland.

It is hoped that this report will be of assistance to institutions, agencies and individuals who are in a position to advise fishermen on business matters.

FRANK DOPPLINGER
Chairman

INCORPORATION AND THE NEWFOUNDLAND INSHORE FISHERMAN

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1.00 INTRODUCTION

1.00 Introduction

1.01 Scope of Study

As time goes on, more and more inshore fishermen (throughout this study, the terms "fishermen" and "fisherman" are used to include both male and female people involved in the inshore fishery) are considering the possibility of incorporating their fishing businesses. Before making the decision on whether or not to incorporate a fishing business, many factors need to be considered. In order to be able to provide inshore fishermen in Newfoundland with an analysis of most of the factors requiring prior consideration, the Fishing Industry Advisory Board commissioned this study. It is hoped that this study will be of benefit to the fisherman considering incorporation because that is the primary purpose of the study.

This study attempts to analyse and discuss the most important factors to be considered by a fisherman prior to making the decision to incorporate. Some factors are advantages of incorporation and some factors are disadvantages, but not all factors will be viewed in the same light by all fishermen. Depending on the circumstances in a particular fishing business, one fisherman might consider a factor an advantage while another fisherman, because of his circumstances, might well consider the factor a disadvantage.

Take, for example, a fishing business with owners A, B and C. This fishing business has $200,000 of taxable income in the year. If this business were incorporated, the total

income tax paid by A, B and C and their corporation could be less than would have been paid by A, B and C if their business was unincorporated. Consequently, A, B and C would probably regard tax as an advantage of incorporation. On the other hand, another fishing business with owners X, Y and Z has $200,000 of losses in the same year. If this business were incorporated, X, Y and Z would not be able to use the $200,000 loss personally. The loss must stay in the incorporated business and is unavailable to X, Y and Z; accordingly, X, Y and Z would probably regard tax as a disadvantage of incorporation. This discussion of tax is simplified in order to explain how the circumstances of two different fishing businesses determine whether the owners of those businesses would regard a factor as an advantage or a disadvantage of incorporation. There are other aspects of tax, and other factors, which are considered in greater detail in other following parts of this study.

The study, however, does not cover everything unless incorporation would change the effect. For example, the study does not consider the investment tax credit in the area of income tax (and which can result in significant tax savings as well) because the effect on the fishing business is the same, whether or not the fishing business is incorporated, except in the one specific area of scientific research, which is discussed in section 3.02(3). The study is restricted to those things which would change if the fishing business was incorporated.

In addition, it will be noted that there is no conclusion in the study. It does not state whether or not a fishing business should be incorporated, but it does specify the relevant considerations. A conclusion in a study of this nature (as a result of the general nature of the considerations) would be inappropriate because the conclusion depends on the circumstances of the particular fishing business, and that information was beyond the scope of this study. But consideration of the features will provide a guide for the adviser to the fisherman considering incorporation.

1.02 Corporation

(1) Definition

Generally the terms "company" and "corporation" are used interchangeably to describe an incorporated business with the liability of the owners limited to the amount agreed to be contributed for their shares. However, because the term "company" is also used to describe an unincorporated business as well as an incorporated business without limited liability, there is an increasing trend toward the use of the term "corporation" to describe an incorporated business with limited liability. Accordingly, in order to avoid confusion with unincorporated businesses and incorporated businesses with unlimited liability, the term "corporation" is used in the remainder of this project to mean an incorporated business with limited liability.

(2) Distinguishing Feature

The principal feature which distinguishes a corporation from other forms of business organization is limited liability. The liability of the owners is limited to the amount agreed to be contributed to the corporation for their shares. In law, the corporation is generally regarded as another person separate and distinct from the owners of its shares. For example, if A, B and C formed a corporation called ABC Fishing Limited, the law normally treats ABC Fishing Limited as a fourth person, separate and distinct from the three owners or

shareholders, A, B and C.

However, there are limited circumstances in which the separate legal personality of ABC Fishing Limited could be disregarded by the law. In certain cases involving taxation, residence, agency and fraud, the separate personality of ABC Fishing Limited could be disregarded, but these are relatively unimportant for our purposes so long as the proper corporate procedures are followed and the corporation is not used for fraud or improper conduct.

1.03 Relevant Date

Laws change, and as a result, it is necessary to state that the contents of this paper speak as of 30 June 1980. However, this does not mean that proposed changes to the law that were known on 30 June 1980 have been ignored. An attempt has been made to insert the proposed changes in the material and to identify them as proposals. But the reader is cautioned against accepting the proposals until the proposals are enacted into law.

1.04 Professional Advice

Incorporation and the factors to be considered before incorporation are complex, technical subjects. An attempt has been made throughout this paper to explain and discuss in layman's terms the various considerations. However, after a consideration of the subject matter of this paper, the reader is advised to consult with his professional accounting and legal advisers who, by virtue of their knowledge of the personal circumstances of the fisherman, may well be able to suggest additional personal considerations, as well as to tailor a corporation to fit the needs of the individual fisherman or group of individual fishermen and their families.

In the course of the preparation of this report, many individuals gave of their time to discuss various aspects with me, and I wish to express my appreciation to them. Space does not permit my naming every one of them, but I would like to name the following: Messrs. H. Hamilton and J. Mackey, Fishermen's Management Services Limited; Mr. F. Power, Department of Fisheries; Messrs. F. O'Brien, L. Rowe and R. Green, Department of Fisheries and Oceans; Mr. Miller, Workers' Compensation Board; Mr. D. Hall, Department of Consumer and Corporate Affairs; Messrs. E. Leonard and R. Whitaker, College of Fisheries; Mr. D. Chapman, Newfoundland Fishermen, Food and Allied Workers' Union; Messrs. A. Boulanger and B. Willis, Finance Canada; Messrs. Hoysak,

M. Hanna and J. Vogan, Revenue Canada (Taxation); and Mr. L. Edwards, Fisheries Loan Board. In addition, Messrs. F. Dopplinger and M. Handrigan, Fishing Industry Advisory Board, were kind enough to review the draft report and to give valuable comments.

Although the report is the product of the comments of many gifted and stimulating people, I must accept the final responsibility for what it contains.

1.05 Outline of Paper

As was mentioned previously, the aim of this project is to discuss most of the factors that would be considered by an inshore fisherman in Newfoundland contemplating incorporation. For convenience, the various factors are grouped according to the following general outline:

2.00 General Corporate Features

This part analyses and discusses general corporate features that would generally be considered by any person contemplating incorporation of any business.

3.00 Income Tax Features

This part analyses and discusses features of taxation law relevant to anyone contemplating incorporation of a business, as well as those features specifically related to the incorporation of a fishing business.

4.00 Government Regulation Features

This part analyses and discusses the impact of incorporation on unemployment insurance, workers' compensation, fishing licences and federal and provincial assistance programs.

5.00 Status in Union

The status of the incorporated fisherman within the Newfoundland Fishermen, Food and Allied Workers' Union is

6.00 Methods of Incorporation Features

The effect of incorporation under the federal law and Newfoundland law is analysed and discussed.

7.00 Conclusion.

1.06 Glossary of Terms

In this study, a number of technical terms are used, and this glossary of terms has been prepared in order to give the reader a basic understanding of some of these terms. However, in many cases, the definition of these terms is cryptic, and to fully appreciate the significance of these words, it may be necessary to consult professionals in the field.

Compulsory buy-sell clause, or roulette clause, or shotgun clause are all clauses which, in the event a shareholder of a corporation is dissatisfied with the operation of the corporation, forces the other shareholder to either buy the dissatisfied shareholder's shares or to sell his shares to the dissatisfied shareholder.

Cumulative voting is a provision which at times permits minority shareholders to elect a member of the board of directors, the usual governing body of the corporation.

Equity or equity capital means the capital of the corporation that has been contributed as a result of the purchase of shares, and the holders of the shares are the persons who receive nothing from the corporation until after all the creditors are paid in full.

Legal person means a something that is recognized by the law as a person, even though the legal person may not be an individual. For example, if individual A incorporates A Limited, the law regards A and A Limited as two separate legal persons, even though there is only one individual A.

Partnership basically means an operation carried on by two or more persons with a view to making a profit from the operation. In a general partnership, all the partners have unlimited liability for the actions of the partners in the course of the business. On the other hand, in a limited partnership, only the general partners have unlimited liability, while the limited partners are liable only for the amount they have agreed to contribute to the partnership. In order to remain limited partners, however, they must remain silent partners in that they cannot take part in the management of the limited partnership. If limited or silent partners take part in the management of the limited partnership, they can become general partners and thereby would be subject to unlimited liability.

Personal asset is an asset which is owned by an individual for his own personal use.

Pre-emptive right is a right which is sometimes given to existing shareholders which requires that any additional

shares to be issued by the corporation be first offered pro-rata to existing shareholders before any offer to others. Otherwise, the directors may issue new shares to others and dilute the interest of the existing shareholders.

Quorum requirements. In some cases, there can be a provision which requires minimum or unanimous attendance before a legally constituted meeting of shareholders or directors can be held. If a shareholder or director, in the case of a unanimous attendance requirement, does not want the corporation to proceed, the shareholder or director can prevent the passage of resolutions.

Super-majority requirements provide that specified resolutions, either at meetings of shareholders or directors, cannot be passed without the consent of a super, or greater than the normal over 50 percent, majority. This can at times permit a minority to block actions that he does not approve of. For example, let us assume a minority shareholder owns 15 percent of the voting shares and that there is a requirement for passage of resolutions at shareholders' meetings of 90 percent of the voting shares outstanding. In such a case, the super-majority requirement of 90 percent permits the minority shareholder with 15 percent to block any actions of which he does not approve.

2.00 GENERAL CORPORATE FEATURES

2.00 General Corporate Features

2.01 Introduction

In this part of the project, consideration will be given to the general features of incorporation that would be considered by anyone intending to incorporate a business. The most widely publicized feature is limited liability, but there are others, and these others will also be analysed and discussed. In addition, where types of business organization other than incorporation would provide the same or similar type of feature, these are also mentioned.

2.02 Limited Liability

(1) General

In essence, limited liability means that the liability of an individual shareholder for debts of a corporation is limited to the amount the individual shareholder has agreed to contribute to the corporation for his shares. Only the amount agreed to be contributed for his shares could be taken to satisfy claims of creditors . And, assuming the full amount agreed to be contributed for his shares has been fully paid, the creditors of the corporation could not look to any assets owned personally by the individual to satisfy debts of the corporation.*

For example, let us assume for simplicity that A, a fisherman, owns only two things - a home worth $30,000 and a boat worth $100,000 on which there is no insurance. The home is fully paid for but A owes $30,000 on the boat. Let us further assume that the boat sinks and is a total loss. In this situation, A's creditors could seize the fully paid home to pay for the $30,000 debt on the boat.

On the other hand, let us assume A had incorporated his fishing business into A Limited, with the boat owned by A Limited and the $30,000 loan on the boat taken out in the name of A Limited. Of course, we also assume A's home would be owned by A personally and not by the corporation, A Limited.

*(This, of course, assumes that proper corporate procedures had been followed and the corporation was not an instrument of fraud or improper conduct.)

In this case, the result would be different if the boat sank and was a total loss, because the creditors who are owed $30,000 on the boat by A Limited would not be able to take the home registered in A's name. To be sure, A would lose the $70,000 in equity built up in the boat, assuming his investment in A Limited was through the purchase of fully paid shares, but he would not lose his $30,000 home.

(2) Qualifications

(a) Lenders

Having read the previous example, one could easily surmise that incorporation is the answer for anyone owing any money. But the answer does not come that easily, because lenders are not stupid and have devised ways of avoiding the limited liability of corporations like A Limited. The most common device used by lenders to make certain that A's personal assets - in our example, A's $30,000 home - are available to satisfy the debts of A Limited, is the personal guarantee. In the majority of cases,before a lender would be willing to lend money to a corporation such as A Limited, the lender would require a personal guarantee from A, which would then make A's personal assets available to satisfy the debts of A Limited.

(b) Lessors

People who lease property to corporations

such as A Limited could, but customarily would not, require a personal guarantee from A, but they can always take back their property where the rent is not paid. Consequently, limited liability would only be advantageous where no personal guarantee is required and the property is destroyed, with no assets in the corporation to satisfy the debt.

(c) Suppliers on Credit

Suppliers of goods and equipment to corporations may, particularly when the business is just beginning and no credit rating has been established, require payment before delivery. However, once the corporation is established with a credit rating, suppliers will normally supply goods and equipment to a corporation on credit without a personal guarantee. In this event, if the corporation A Limited were to fail, the personal assets of A would be protected against claims of the suppliers to A Limited.

(d) Damage to Others

In some cases where damage is caused to the property of others without any fault on the part of anyone, limited liability can provide protection. Let us assume that A personally owns a $30,000 home and A Limited owns only one asset, a $100,000 fishing boat. Both the home and the boat are completely paid off, but there is no insurance on either. One night when the A Limited boat is tied up at the wharf, the boat blows up and demolishes another

$200,000 boat. The owner of the demolished $200,000 boat would only be able to claim against A Limited and accordingly, the $30,000 home owned by A personally would be protected. On the other hand, if A had personally owned both the $30,000 home and the $100,000 boat, the owner of the $200,000 boat could well have taken A's home.

(3) Alternatives to Incorporation

In some cases, there are things other than incorporation that can be done that will give similar protection against the loss of personal assets.

(a) No Personal Assets

In some situations, taxpayers have arranged their affairs such that most personal assets are owned legally by another person, usually a spouse. For example, in the preceding group of examples, if A's spouse had legally owned the family home, the family home would not have been available to satisfy the debts or claims against A's business, even if the business was unincorporated.

A word of caution is advised with respect to this procedure to protect personal assets. Firstly, if a home is legally transferred to a spouse, then legally it belongs to the spouse and if the marriage fails, the home belongs to the spouse, who has legal title to the home. In addition, the Matrimonial Property Act becomes law in Newfoundland on 1 July

1980, which will automatically give each spouse a one-half interest in the matrimonial home unless the two spouses execute an agreement stating that the Act does not apply.

Secondly, in making a transfer of property to a spouse, one must be cognizant of another piece of legislation, the federal Bankruptcy Act. Transfers made when a person is insolvent or within a year of bankruptcy can be retrieved and used to satisfy claims against the transferor.

(b) Insurance

In many situations, insurance can be purchased on business assets which will protect personal assets (but possibly not totally) against claims due to the destruction of the asset or due to damage caused by others. However, it is usually not economically possible to insure against business failure caused by insufficient profits to pay off debts. Accordingly, to guard personal assets against business failure due, for example, to a poor fishing season and to guard personal assets against business failure due to the occurrence of an uninsurable risk, incorporation may well be the answer.

However, incorporation only protects personal assets from claims against the business. It does not protect business assets, and the corporation which wishes to protect its assets would be well advised to purchase insurance against insurable risks. Take, for example, the corporation A Limited,

which owns a $100,000 fishing boat on which it owes a lender $30,000. If this boat were to sink, A Limited would lose the total $70,000 in equity that it has built up unless A Limited had insured against the risk of the boat sinking. Accordingly, incorporation, together with insurance, may be appropriate.

2.03 Prestige

Some people argue that an incorporated business has more prestige in dealing with other businesses. But the value of this factor is practically impossible to measure, or is intangible. Consequently, not much weight would be attached to this factor by many businessmen, but it has been included here for completeness.

2.04 Participation in Profits and Capital

At times it is argued that giving workers a share in the business gives them more motivation to work towards the success of the business than merely paying them a salary or wages. And it is further argued that the most effective way of accomplishing this is to incorporate and give them shares in the corporation, with the businessman owning a majority of the shares so management would remain in the hands of the businessman. Giving workers shares in a corporation permits workers to share in profits and also permits them to share in the capital appreciation of the assets of the business.

However, this factor may not be as relevant to fishing businesses as it could be to non-fishing businesses. Many fishing businesses are operated presently on a sharing basis rather than on an employer-employee basis, and for this reason the workers would already be sharing in the profits of the business. However, they would not be sharing necessarily in the capital appreciation of the assets, such as the boat. If it is considered desirable to have workers sharing in the capital appreciation of the assets, then a corporation with shares issued to the workers may be an effective way of accomplishing this.

On the other hand, if the fisherman is only interested in this particular feature of incorporation, a partnership may be a less expensive alternative. But it must be noted that while a partnership could achieve the desired sharing and

management objective, it may not achieve other objectives, such as limited liability unless a limited partnership was used.

2.05 Additional Equity Capital

Equity capital is capital which is invested in a business and is the last to be paid back when the business is terminated. Equity capital is paid back only after the claims of creditors have been satisfied. And because it is the last to be paid back, it is the most risky of all investments in a business.

It is sometimes easier to raise equity capital from outsiders for a business when the business is incorporated. The reason for this is the limited liability feature of a corporation. The outsider who invests equity capital in an incorporated business knows, assuming the business is legitimate and correct corporate procedures are followed, that he can only lose what he has agreed to invest in the business. On the other hand, in most unincorporated businesses, the outsider who invests equity capital will have to worry about claims being made against his other assets in the event the business fails. Consequently, it is sometimes easier to raise outside equity capital when the business is incorporated.

On the other hand, if the only concern of the fishing business is to provide limited liability for the outsider who wishes to invest equity capital and who wishes to take no part in the operation of the fishing business, it can sometimes be less expensively accomplished through the establishment of a limited partnership. One must be cautious, however, in

establishing a limited partnership and make certain that the outsider who invests equity capital is truly a "silent partner", because if the outsider who invests equity capital becomes involved in the management of the fishing business, he could well lose the protection of limited liability.

2.06 Perpetual Existence

A corporation,being a legal person separate and distinct from its shareholders, also has a life separate and distinct from its shareholders. And, assuming all the legal requirements are met, the life of the corporation is perpetual. The corporation continues its existence despite the death or withdrawal of a shareholder.

On the other hand, unincorporated businesses can be terminated on the death or withdrawal of an owner. Provision can be made in a partnership agreement to continue partnership on the death or withdrawal of a partner, but no special provision is necessary to continue a corporation, and it may make the process on the death or withdrawal of an owner a little easier.

2.07 Complexity and Expense

Of all the forms of business organization, the corporation is normally the most complex and expensive to establish and to operate. In order to establish a corporation, certain documents must be prepared and submitted to the governments. These documents must be certified by a lawyer if you are incorporating under the laws of Newfoundland and, although it is not absolutely necessary to use the services of a lawyer to incorporate federally, it is advisable, particularly where there is more than one shareholder and to prevent problems in the future resulting from a lack of understanding of the requirements of the law. In addition, the governments charge a minimum of $215 federally and $115 provincially for a name clearance (no fee for name clearance provincially) and registration of the various documents which are necessary for incorporation. It is also necessary to register a federal corporation in Newfoundland in order to carry on business in Newfoundland, and this registration will cost an additional minimum of $32. Share certificates and a corporate register will be needed and, if incorporating under the laws of Newfoundland, a corporate seal must also be obtained, but the prices of these vary.

Subsequent to incorporation, the governments require that an annual return be filed, together with an annual filing fee of $25 under the laws of Newfoundland and $30 under the federal law, and if the federal corporation files an annual return in Newfoundland, this will cost an additional $120.

Furthermore, since a corporation is a separate legal person, it must be treated separately from its shareholders financially. Accordingly, a corporation must have its own separate accounting records, and the shareholders must keep another set of records for their affairs. In an unincorporated business, one set of records may suffice, but even in an unincorporated business, personal and business expenses still are supposed to be kept separately. In addition, again because the corporation is a separate legal person, an income tax return must be filed by the corporation and another income tax return by each shareholder if the shareholder receives income.

Costs will be incurred in changing the incorporating documents of the corporation, but if these are carefully prepared initially, such costs may be avoided. If at some point it becomes desirable to terminate a corporation, there may well be costs involved in this as well.

It should be noted at this point that the establishment and operation of a partnership can be just about as expensive and complex as the establishment and operation of a corporation, but the government filing fees* and the cost of a seal, share certificates and corporate register may be avoided. But there is a proposed* Registration of Partnerships Act which, it appears, will impose government filing fees, but the amount is uncertain at this time.

*There is also at present a Limited Partnerships Act in force in Newfoundland which requires registration and disclosure; however, the government is refusing to register limited partnerships at present, preferring to wait until the proposed new Registration of Partnerships Act is enacted.

2.08 Privacy

Incorporation under the law of Newfoundland requires annual disclosure of names, addresses and occupations of each shareholder and director, together with the number of shares held by each and details of each share issue. In addition, a corporation incorporated under the law of Newfoundland is required to disclose annually the amount of debt outstanding by the corporation in the form of mortgages and charges. And the foregoing information is available to any member of the public. Similar information would normally be filed annually by corporations incorporated federally who carry on business in Newfoundland. And, unless exempted, a federal corporation with gross revenues in excess of $10,000,000 or gross assets in excess of $5,000,000 must also file copies of its financial statements, which are available to the public.

In addition, corporations incorporated under the law of Newfoundland are required to maintain a register of mortgages and charges, while a federal corporation is required to maintain a register of all debt instruments, and these registers are open to inspection by any creditor or shareholder of the corporation.

Public disclosure such as that mentioned in the preceding two paragraphs is not required of unincorporated businesses and, as a result, the unincorporated business is a little more private than is the incorporated. However, no business is ever completely private, because the tax authorities and lenders normally require a certain amount of disclosure.

2.09 Control

A majority shareholder in a corporation holds in excess of 50 percent of the issued voting shares of a corporation. Any shareholder who is not a majority shareholder is referred to as a minority shareholder. And generally, the minority shareholder is subject to the will of the majority shareholder, and in a closely-held corporation (i.e. few shareholders), the shares held by the minority shareholder are not a very saleable product.

However, provision can be made to alleviate, but not avoid, some of the problems inherent in the position of a minority shareholder, such as compulsory buy-sell or "roulette" or "shotgun" clauses, super-majority requirements for director and shareholder meetings, quorum requirements for meetings, pre-emptive rights on the issue of new shares, and cumulative voting for directors.

On the other hand, unless otherwise agreed between the partners, a minority partner can dissolve a partnership at any time by giving written notice. Consequently, unless there is an agreement to the contrary, the minority partner in a partnership will not have the same difficulty as a minority shareholder might have in leaving the partnership and taking his money.

It should be noted that some shareholders in a corporation may desire dividends, rather than salary, bonuses or fees. If such is the case, it may be appropriate to have more than one class of shares in order to accommodate such preferences.

3.00 INCOME TAX FEATURES

3.00 Income Tax Features

3.01 Introduction

Generally, this part of the report analyses and discusses the features of the income tax law which have a bearing on the decision of whether or not to incorporate. Section 3.02 discusses the factors that could have an impact on the decision to incorporate any type of business with reference, where appropriate, to the incorporation of a fishing business. Section 3.03 discusses factors which apply specifically to a fishing business and also discusses the impact of income tax on the incorporation of a fishing business. And then, because some taxpayers use devices other than incorporation to defer or save tax, some alternatives to incorporation are discussed in section 3.04.

3.02 Business Incorporation

(1) Small Business Deduction

Before turning to a consideration of the small business deduction, it is important to determine what rates of tax a Newfoundland business would pay on its taxable income if it was not incorporated. An unincorporated business with taxable income of $10,000 would pay federal and Newfoundland income taxes of approximately $2,500 or 25 percent where the only tax reduction was the special tax reduction. An unincorporated business with taxable income of $20,000 would pay federal and Newfoundland income taxes of approximately $6,000 or 30 percent where the only tax reduction was the special tax reduction. An unincorporated business with taxable income of $30,000 would pay federal and Newfoundland income taxes of approximately $10,600 or 35 percent where the only tax reduction was the special tax reduction.

In addition, an unincorporated business with taxable income of $150,000 would pay federal and Newfoundland income taxes of approximately $84,400 or 56 percent where the only tax reduction was the special tax reduction. In other words, the business earning $150,000 of taxable income in essence pays 56 cents out of every dollar in income taxes. However, because we have a progressive income tax system in Canada applicable to unincorporated income, very little is taken from each dollar of taxable income under $2,000, but on taxable income in excess of $108,360, approximately 67.9 cents is taken from each dollar of earnings.

The small business deduction is applicable only to Canadian-controlled private corporations and is applicable to the first $150,000 of active business income of these corporations. It does not apply to public corporations such as Newfoundland Telephone Company Limited nor to foreign-controlled corporations such as Bowaters (Newfoundland) Limited. Nor does it apply to passive taxable income such as income from investments.

But where it does apply, it effectively taxes the first $150,000 of Newfoundland taxable income of a corporation at 27 (27.75 if the 5% corporate surtax is imposed) percent; in other words, a corporation with taxable income of $150,000 would pay federal and Newfoundland income tax of approximately $40,500 assuming no other deductions are applicable. As compared with the unincorporated business with $150,000 of taxable income, there would be a saving of $43,900. However, if you compare the tax on a corporation with $10,000 of taxable income with an unincorporated business with $10,000 of taxable income, the corporation would pay $200 more. If you also compare a corporation with $30,000 of taxable income with an unincorporated business with $30,000 of taxable income, the corporation pays $2,500 less in taxes , but bear in mind that it costs more money to incorporate and operate an incorporated business.

The foregoing examples hopefully show that the small business deduction is much more valuable as a method of saving money to the business with higher earnings. Consequently,

anyone considering incorporation for the small business deduction must carefully consider the earnings* of the business before making the decision. But the deduction has another limitation. Once the corporation has in essence accumulated $750,000 in earnings in the corporation, the corporation loses the small business deduction and will thereafter pay federal and Newfoundland income tax at the same rate as it does on annual active business income over $150,000, i.e. 51 (52.8 if the 5% corporate surtax is imposed) percent. In other words, if a corporation that was no longer eligible for the small business deduction had taxable income of $150,000, it would pay federal and Newfoundland income tax of $76,500, which is a saving of only $7,900 over the unincorporated business described previously with $150,000 of taxable income.

However, one way to reduce the amount of accumulated earnings in a business is to pay out dividends. And a shareholder with no other income can receive approximately $30,000 in dividends a year and pay no income tax on the dividends as a result of the dividend tax credit.

*The discussion in this section of the report has only considered active business income and not passive investment income, as that was considered beyond the scope of the study.

(2) Deferred Profit Sharing Plans*

Deferred profit sharing plans can only be used where an employer-employee relationship exists.* A self-employed person cannot set up a deferred profit sharing plan because he cannot be an employee of himself; however, he can be an employee of a corporation because the corporation is a separate legal person which can be qualified as an employer.

For example, a self-employed fisherman X could not set up a deferred profit sharing plan for himself because there would be no employer-employee relationship. However, X could incorporate X Limited and become an employee of X Limited. X Limited would be the employer and X would be the employee.

In such a situation, X Limited would pay X a salary of $17,500, which would be a deductible expense to X Limited, and X would be taxable on the $17,500 salary as employment income. X Limited could then pay the lesser of $3,500 and 20 percent of the salary paid into a deferred profit sharing plan. In our example, the maximum that could be contributed by X

*An employer-employee relationship normally also qualifies for the establishment of a registered pension plan which can also bring income tax benefits to an employee in the form of tax deductible contributions by both the employer and employee. However, where the registered pension plan is primarily for the benefit of the principal shareholders of a corporation, it is referred to as a "top hat" pension plan and it may not be possible to get the authorities to accept the plan for registration.

Limited (which would be a deductible expense to X Limited) is $3,500, which is 20 percent of the $17,500 salary. The $3,500 contribution by X Limited would be invested by the deferred profit sharing plan for X, but it is not taxable to X until X removes it from the deferred profit sharing plan.

In addition, the $3,500 payment by X Limited to the deferred profit sharing plan does not affect the amount that X is permitted to invest in a registered retirement savings plan. X would be permitted to contribute the lesser of $5,500 and 20 percent of $17,500 into a registered retirement savings plan. This means that, in addition to the $3,500 X Limited has contributed into a deferred profit sharing plan for X, X would be able to contribute an additional tax deductible amount of $3,500 into a registered retirement savings plan.

It may also be possible with a corporation for X to improve his position even further through the use of a "flip-flop". This is a very technical operation, but in essence it involves the use of a deferred profit sharing plan together with a registered pension plan in year one, and then in year two, a registered pension plan with present and past service contributions, with year one being repeated in odd numbered years and year two being repeated in even numbered years. Where such a device is used, it can have the effect of doubling the available deductions and potential benefits. However, before attempting a "flip-flop", it is crucial that professional advice be obtained.

In addition, an employer is entitled to purchase group term life insurance of up to $25,000 for each of the employees, without the cost of the insurance being included in the income of the employee. And a corporation could well provide the needed employer for the fishermen.

(3) Scientific Research

To begin this discussion, we will start with a well-known income tax principle that everyone is probably already familiar with. That is, that current expenses that are expended to earn business income and are reasonable are 100 percent deductible in the year in which they are incurred (if using the accrual method of accounting) or the year in which they are paid (if using the cash method of accounting, which unincorporated, self-employed fishermen are permitted to use). Current expenses on scientific research are also 100 percent deductible in the year in which they are incurred or paid, depending on the method of accounting used.

Capital expenditures for assets used in a business that are expected to last more than a year are treated differently. They are usually placed in a capital cost allowance class and depreciated at maximum rates specified by the government. If a fisherman acquired an outboard motor in 1980 for use on a boat used for ordinary business purposes, the maximum proportion of the cost of the motor that could be depreciated in 1980 would be 30 percent. However, if the same motor was acquired for use on a boat to be used for scientific research purposes, 100 percent of the cost of the motor could be deducted in 1980.

In addition, if the business is incorporated, it may also qualify for an additional deduction equal to 50 percent of increases in scientific research expenditures over previous

years. But this 50 percent is only applicable to corporations, and not to unincorporated businesses.

The scientific research does not necessarily have to be carried out by the business itself; it can be contracted out. The cost of paying someone else to do the research for the business is deductible as well.

The definition of scientific research is a technical one and reproduced in full in the following:

> "Scientific research" means systematic investigation or search carried out in a field of science or technology by means of experiment or analysis, that is to say,
> (a) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view,
> (b) applied research, namely, work undertaken for the advancement of scientific knowledge with a specific practical application in view, or
> (c) development, namely, use of the results of basic or applied research for the purpose of creating new, or improving existing, materials, devices, products or processes,
> and where such activities are undertaken directly in support of activities described in paragraph (a), (b), or (c), includes activities with respect to engineering or design, operations research, mathematical analysis or computer programming and psychological research, but does not include activities with respect to
> (d) market research or sales promotion;
> (e) quality control or routine testing of materials, devices or products;
> (f) research in the social sciences or the humanities;
> (g) prospecting, exploring or drilling for or producing minerals, petroleum or natural gas;
> (h) the commercial production of a new or improved material, device or product or the commercial use of a new or improved process;
> (i) style changes; or
> (j) routine data collection.

Ordinarily, where an unincorporated business incurs expenses on prescribed buildings, equipment and machinery to

be used in carrying out scientific research in Newfoundland, the business is entitled to a special research investment tax credit equal to 20 percent of the cost. On the other hand, where the same expenses are incurred by a Canadian-controlled private corporation eligible for the small business deduction, the corporation is entitled to an investment tax credit equal to 25 percent of the cost.

(4) Salary for Spouse

In many cases, the spouse of the fisherman is actively participating in the fishing business. And while it is possible to pay the spouse a salary as an employee of the business, it is not possible to deduct the salary paid to the spouse for income tax purposes. At present, in order to deduct the salary for income tax purposes, it is necessary to incorporate the business.

However, it may not in future be necessary to incorporate to be able to pay a salary to a spouse and deduct it for income tax purposes. Two governments - a Progressive Conservative one in December 1979 and a Liberal one in April 1980 - have announced that for 1980 an unincorporated business will be able to deduct a salary paid to a spouse for income tax purposes.

In any event, when considering the payment of a salary to a spouse, one must also take into consideration the loss of the marital exemption of $2,530 in 1980 and that the spouse may be required to pay tax on the salary.

(5) Income Averaging Annuities

Let us assume that a businessman bought a piece of land in 1972 for $10,000 as an investment and sold the same piece of land in 1980 for $110,000. Now, if this was a capital gain transaction, there would be a capital gain of $100,000 ($110,000 minus $10,000). Of the $100,000 capital gain, 50 percent or $50,000 would be income in the year in which the sale took place and the price was received. The tax on the $50,000 could be quite high, but the total tax payable could be reduced by purchasing an income averaging annuity which would spread the receipt of the money as well as the payment of the tax over a number of years.

The income averaging annuity device, however, is only available to individuals. And if, in the foregoing example, a corporation had the capital gain of $100,000 in 1980, $50,000 would have been included in the income of the corporation and the corporation could not use an income averaging annuity to postpone the tax.

In a lot of cases, the inability to use an income averaging annuity may not be an important consideration, but in addition to capital gains, the following types of receipt are also eligible for the acquisition of an income averaging annuity:

(a) a refund of premiums under a registered retirement savings plan,

(b) recaptured depreciation on disposal of depreciable property,

(c) amounts withdrawn from a registered home ownership plan,

(d) a receipt of income from the sale of eligible capital property such as a fishing licence, and

(e) a receipt of income on amounts realized from accounts receivable on the disposal,or ceasing to carry on a business or part of a business.

(6) Deductibility of Losses

In this discussion, we are concerned about two types of losses. The first is a capital loss, and the second is a non-capital loss.

Capital losses result from the disposal of non-depreciable assets such as land. Let us assume that our fisherman X purchased a piece of land as an investment in 1972 for $20,000 and in 1980, no longer wanting it, sold it for $2,000. The capital loss would be $18,000 and allowable capital loss for tax purposes could be $9,000. The unincorporated fisherman with no capital gains would be able to deduct $2,000 in 1980 against other income, $2,000 back against other income in 1979, $2,000 in each succeeding year until the $9,000 was fully deducted. On the other hand, if the business that owned the land in question had been incorporated as X Limited, X Limited would be unable to deduct the $9,000 allowable capital loss except against taxable capital gains of X Limited, which may never materialize. In addition, because

the allowable capital losses of X Limited remain the property of X Limited, allowable capital losses of X Limited could not be deducted against taxable capital gains that X made personally.

Non-capital losses are most usually losses other than capital losses and normally occur when the expenses of a business exceed the income of a business. And where our unincorporated fisherman X has expenses exceeding income in 1980 by $10,000 in his fishing business and has income from other employment of $30,000, X would be able to deduct the $10,000 non-capital loss in the fishing business from the $30,000 of other income, to give an income for income tax purposes of $20,000. On the other hand, if the fishing business had been incorporated as X Limited, and the fishing loss of $10,000 had occurred in X Limited with the $30,000 having been earned personally by X, for 1980 X would have had an income for tax purposes of $30,000 without being able to deduct the $10,000 loss from the incorporated fishing business. Granted, X Limited could carry the $10,000 loss back to 1979 and deduct it there, and if it was not all used up in 1979, then could carry it forward to deduct it from profits in the succeeding five years. The point here is that losses of the corporation remain losses of the corporation and cannot be used by the owners of the corporation. There may be a partial writeoff for the shareholders of a corporation on the disposal of the

shares or debt of the corporation under the allowable business investment loss rules, but this discussion has assumed that the fisherman does not wish to dispose of his investment in the corporation which owns the fishing business.

(7) Fiscal Year End

When a business is started, the business is entitled to select any fiscal year end that is desired, so long as the length of the fiscal year does not exceed 12 months. Many businesses choose a 31 January year end, albeit for business purposes, but also to defer payment of income tax because in many cases a dollar of tax deferred results in more income to the business.

On the other hand, if a business inadvertently selects 31 December as the fiscal year end, there would be no income tax deferral. Now, if a business had selected a 31 December year end and desired to change to another year end, the Income Tax Act does permit a change, but the change must be agreed to by the government, but normally the government will only agree to a change for legitimate business reasons, and the saving of income tax is not considered to be a legitimate business reason.

For the business which had originally selected a 31 December year end for the business, and desires a change, some businesses have turned to incorporation as a method of changing the year end of the business. When a business is

incorporated, the new corporation can select any fiscal year end it desires, so long as the period chosen for the fiscal year does not exceed 53 weeks.

(8) Manufacturing and Processing Deduction

The manufacturing and processing deduction probably has limited application to most fishing businesses which merely catch fish and sell them, as a result of the following exclusions:

(a) farming and fishing,

(b) logging,

(c) construction, and

(d) manufacturing and processing where less than 10 percent of the gross revenues from active business carried on in Canada is from the selling or leasing of goods manufactured or processed in Canada and from manufacturing and processing in Canada of goods for sale or lease by others.

However, where the fishing business is also involved in processing the fish in a significant way, the manufacturing and processing deduction has the effect of reducing the corporate income tax rate on active business manufacturing and processing income eligible for the small business deduction from 27 percent to 22 percent (27 becomes 27.75 and 22 becomes 22.5 if the 5% corporate surtax is imposed). For other active

business manufacturing and processing income of corporations, the corporate income tax rate would be reduced from 51 percent to 45 percent (51 becomes 52.8 and 45 becomes 46.5 if the 5% corporate surtax is imposed).

In considering whether or not a portion of the fishing business's active business income would be eligible for the manufacturing and processing deduction, it is important to consider the following government statements on the subject:

> Fishing
>
> Fishing includes fishing for or catching of shell fish, crustaceans, and marine animals and any incidental activities of a fisherman carried out on board the fishing vessel. Once the fish are caught and transported to a fish-processing plant or cannery, any activities carried out to prepare the fish for market, such as filleting, shelling, icing, canning, freezing, smoking, salting, cooking and pickling, are considered to be processing activities. Generally, most of these processing activities will be carried out on shore and thus a fisherman will not ordinarily be engaged in processing activities. However, where substantial processing activities are carried out on board a vessel, the Department will not regard the processing activities as constituting fishing provided that there is a clear delineation of the income from fishing and fish processing.
>
> Shipbuilding, etc.
>
> In the case of shipbuilding, aircraft and similar industries, it is the Department's view that movable objects, irrespective of size, are manufactured. Thus, the building of aircraft and ships is not regarded as construction. [And is regarded as manufacturing.]

It must be borne in mind that the manufacturing and processing deduction is only available to incorporated businesses, and not to unincorporated businesses.

(9) Transfers to Children, Grandchildren and Great-Grandchildren

Let us assume that our fisherman X set up his fishing business in 1972 at a cost of $10,000 and in 1980, when he is desirous of transferring the business to his children, grandchildren or great-grandchildren, the fishing business is worth $510,000. If X's fishing business is unincorporated at the time of the transfer, X would have a capital gain of $500,000 on the transfer and $250,000 would be income subject to tax. In other words, if X gave the fishing business to his children, grandchildren or great-grandchildren, he would have received no money but would be required to pay tax on $250,000.

On the other hand, if X's fishing business had been incorporated as X Limited and he had given the shares in X Limited to his children, grandchildren or great-grandchildren, the first $200,000 of capital gains would not be taxable. In other words, $200,000 would have been deducted from the $500,000 actual capital gain, leaving $300,000, of which $150,000 would be taxable. However, the $200,000 would be taxable in the hands of the children, grandchildren or great-grandchildren if they transferred the shares to other than their children, grandchildren or great-grandchildren. In essence, so long as the shares in X Limited remain in the hands of descendants, the $200,000 would not be taxable.

(10) Estate Freezes

It will be noted from the immediately preceding discussion of Transfers to Children, Grandchildren and Great-Grandchildren, that only the first $200,000 of capital gains on the shares of X Limited is exempt, with the remainder being taxable to X. But where X desires to transfer the shares of X Limited to his children, grandchildren and great-grandchildren, it is sometimes possible to effect, through the use of a corporation, an estate freeze after $200,000 in capital gains have accumulated in such a way that the total capital gain would be exempt. An estate freeze would require that an interest in the corporation be given to the children, grandchildren or great-grandchildren when the $200,000 of capital gains had accrued. Other devices such as a trust can also, at times, be used to give X control over X Limited until X is ready to relinquish control to the children, grandchildren or great-grandchildren.

The whole concept of estate freezing is a complex and technical one, requiring detailed and exacting preparation. The concept is presented here with a view to possibly stimulating discussion with professional accounting and legal advisers, who may even consider it prudent to request an opinion from the income tax authorities before proceeding.

(11) Transferring Assets to a Corporation*

Let us assume that our fisherman X has decided to incorporate X Limited and has decided to transfer the assets of his unincorporated fishing business to X Limited. Because X and X Limited are considered two separate persons, the transfer from X to X Limited is considered a sale from one person to another person. And in the case of a sale from one person to another, income tax could normally be payable; however, providing X and X Limited follow the proper procedures under the income tax legislation, which involves the filing of forms with the income tax authorities, no income tax would be payable on the transfer from X to X Limited, but only on the subsequent transfer by X Limited to another person. If, on the other hand, the proper income tax procedures are not followed, X could well have to pay income tax on the transfer to X Limited.

(12) Nothings

Prior to 1972, there were a number of expenditures that were made by a business that were not deductible as expenses and not subject to capital cost allowance or depreciation for income tax purposes. These expenditures were referred to as "nothings", and included the cost of purchasing a government right such as a fishing licence (and included payments made to a person so that the person would allow a

*Most assets used in a fishing business are exempt from provincial retail sales tax, but in the event that the asset being transferred is not exempt, it will be necessary to apply for an exemption from the provincial Department of Finance.

licence to expire so you could acquire a replacement) and the cost of purchasing the goodwill of a business. Now, however, after 1971, if you sell one of these "nothings" that was used in your business prior to 1971 and continuing since 1971, the business may well have a portion of the selling price included in the income of the business. There are two separate sets of rules for "nothings" acquired prior to 1972 - one for government rights and another for all other nothings.

If the business sells a government right acquired prior to 1971 and ceases business in 1980, the amount that would be included in the income of the business in 1980 would be 40 percent* of the amount in excess of the greater of either the cost of the government right incurred prior to 1972 or the fair market value of the government right on 31 December 1971. For example, if a fishing business acquired a government right before 1972 at a total cost of $1,000 and the right had a fair market value of $10,000 on 31 December 1971, and the right was sold for $30,000 in 1980, the amount to be included in income in 1980 is 40 percent multiplied by $30,000 less $10,000, or 40% x $20,000 or $8,000. This beneficial treatment is not lost by transferring the government right acquired prior to 1971 to a corporation controlled by the transferor.

If the business sells another type of nothing acquired prior to 1971 and ceases business in 1980, the amount that would be included in income in 1980 would be 40 percent* of

*42.5 percent in 1981, 45 percent in 1982, 47.5 percent in 1983, 50 percent in 1984 and subsequent years.

the selling price, with no deduction for the cost incurred prior to 1972 and no deduction for the fair market value on 31 December 1971. And furthermore, it appears that, if the business transferred the nothing to a corporation controlled by the transferor in 1980 and the corporation sold the nothing in 1980, the corporation would be required to include 50 percent of the selling price in the income of the corporation, whereas the transferor would only have been required to include 40 percent of the selling price. However, so long as the corporation does not dispose of the nothing until after 1983, there will be no difference because in 1984 and subsequent years, either the transferor or the corporation will be required to include 50 percent of the selling price.

In summary, then, it does not make any difference if a government right acquired prior to 1971 is transferred to a corporation controlled by the transferor. However, it can make a significant income tax difference if any other type of nothing is transferred to a corporation which in turn sells the nothing prior to 1984.

(13) Proposed Small Business Development Bonds

The previous federal Progressive Conservative government and the present Liberal government have announced the establishment of a proposed small business development bond which, it appears, could only be issued by corporations eligible for the small business deduction. At

present, if an incorporated small business issued a bond to a bank, the interest paid on the bond would be deductible to the small business corporation, but the bank would be taxable on the interest earned. However, on the small business development bond of up to $500,000, the bank will be permitted to treat the interest earned as a dividend, and hence pay no tax on the interest. While it is too early to say, as the provision is not yet law, it is suggested that banks will reduce their interest rates on such small business loans because they will not have to pay tax on the interest received. This potentially beneficial treatment will, it is expected, be unavailable to unincorporated businesses.

3.03 Fishing Business Incorporation

(1) Introduction

As mentioned previously, this section of the project analyses and discusses income tax provisions of specific relevance to fishing businesses. As a matter of interest, many of the items discussed in this section are available only to farming and fishing businesses, and are not available to other businesses. And in many cases, the provisions discussed here would be lost if the fishing business was incorporated. Accordingly, the impact of these items warrant special consideration by anyone considering incorporation of a fishing business.

(2) Cash and Accrual Methods of Accounting

Under the cash method of accounting, which is available to unincorporated fishermen*, income is reported in the year in which it is received and expenses are only deducted when they are paid. Inventories are not generally used to compute income according to the cash method, but an exception may be applicable for inventories of nets and traps. If the fisherman historically has deducted the full cost of new nets and traps when they are paid for, he may continue to use this method. If the fisherman has not historically deducted the full cost of new nets and traps, he may be able to (a) claim the actual loss in value of the nets and traps or (b) capitalize the cost of the nets and traps and claim only the capital cost allowance or depreciation permitted by the income tax legislation. Capitalization of the cost and a claim for capital cost allowance as permitted by the legislation is also the method that must be used for most capital expenditures made to acquire an asset or to create an enduring benefit for the business. The cost of acquiring after 1971 a fishing licence or other type of government right is referred to as an eligible capital expenditure, one half of which can be deducted at a rate of 10 percent of the balance remaining at the end of the year.

*Incidentally, there is no statutory authority for fishermen to use cash method, although a departmental publication authorizes it. On the other hand, it is proposed that the cash basis will be statutorily authorized in the near future.

The accrual method of accounting can also be used by unincorporated fishing businesses. The accrual method is the only method that can be used by corporations. And the accrual method differs from the cash method in three basic ways. First of all, income is included in the year in which it is earned, even though payment is not received until a later year, but also, expenses are deductible in the year in which they are incurred, even though they are not paid until a later year. Secondly, all inventories, not just inventories of nets and traps, are used to compute income,which may result in an additional deduction for tax purposes. Thirdly, tangible inventories held for sale in the ordinary course of business are eligible for an inventory allowance. The inventory allowance, which is equal to 3 percent of the amount of such inventory at the beginning of the year, is deductible as an expense of the business, and may result in an additional deduction for tax purposes.

In determining whether or not to incorporate, the fisherman must determine whether or not the cash method is most beneficial. And this requires a consideration of the details of each business, because if the accrual basis would be detrimental to the business, it may not be desirable to incorporate, as an incorporated business can only use the accrual method.

(3) Capital Cost Allowance, Recapture and Terminal Loss

Capital cost allowance is, in essence, the amount of depreciation that you can claim as an expense in a year. Two methods of deducting capital cost allowance may be applicable to fishing businesses - Part XVII and Part XI.

The Part XVII method only applies to assets acquired prior to 31 December 1971 for which no other method of claiming capital cost allowance has been used. The Part XI method of claiming capital cost allowance applies to all other assets. There are four essential differences between the Part XVII and the Part XI methods which are significant to our discussion.

The first essential difference is that no recapture or terminal loss occurs on the disposal of an asset under the Part XVII method, whereas recapture or terminal loss could result under Part XI. Let us assume that a fishing business acquired an asset in 1970 for $10,000 and has taken capital cost allowance or depreciation of $6,000, leaving a balance of $4,000 on the books of the business when the asset is sold at the beginning of 1980 for $9,000. Under the Part XVII method, there would be no effect on the business, but under Part XI, assuming this is the only asset in the class, there would be recapture of ($9,000 - $4,000) $5,000, which would be included in the income of the business for 1980. Let us further assume that our fishing business acquired the asset in 1970 for $10,000 and has taken capital cost allowance or depreciation

of $6,000, leaving a balance of $4,000, but this time the asset is sold at the beginning of 1980 for $3,000. If the asset was in Part XVII, there would again be no effect but, assuming this is the only asset in the class, if the asset was in Part XI, the business could deduct a terminal loss of ($4,000 - $3,000) $1,000. In summary, then, recapture and terminal loss apply to assets in Part XI, but not to assets in Part XVII.

The second difference between Part XVII and Part XI is the available deduction for capital cost allowance when an asset is disposed of during the year. Under Part XVII, where an asset is available for use for 10 months of the year and is then disposed of, the available deduction is 10/12 of the total annual allowance. On the other hand, if the same asset was the only asset in the class and was disposed of after 10 months, no claim for capital cost allowance could be made, although the terminal loss or recapture provisions would be applicable. The reverse also holds true in that if you bought a Part XI asset on the last day of the year, you would get a full year's capital cost allowance deduction.

The third difference between Part XVII and Part XI is the effect of incorporation. Part XVII, as mentioned previously, is only available for assets acquired prior to 31 December 1971. And it appears that if an unincorporated fisherman X were to incorporate X Limited and transfer a Part XVII asset to X Limited, X Limited would not be able to continue to use Part

XVII, but would be required to use Part XI, with all the attendant consequences.

The fourth difference between Part XVII and Part XI is that rates for the deduction of capital cost allowance or depreciation are generally higher for assets covered by Part XI; in many cases, Part XI rates are double the Part XVII rates.

In connection with capital cost allowance, it should be pointed out that some assets are subject to accelerated or increased capital cost allowance rates. A notable example of accelerated capital cost allowance rates is found in the case of fishing boats where, in certain cases, the capital cost allowance rate is increased above the normal rate to one third of the capital cost. And unless this accelerated rate has been used up, the unincorporated fishing business may well want to consider that the benefit of the higher rate could be lost on a transfer to a corporation.

(4) Five Year Block Averaging

Individuals whose chief source of income over a five year period is fishing are able to elect to average their incomes over a five year block period. This factor may be significant because with the progressive tax system in this country, a person with fluctuating income usually pays proportionately more tax than a person with the same total (but level) income from year to year. For example, take two people alike in all respects except for the following - individual A has income in 1979 of $21,000 and income in 1980 of $29,000, whereas individual B has income in 1979 of $25,000 and income in 1980 of $25,000. Over the two year period, the total incomes of both A and B are $50,000, but A will pay more total income tax than B. General averaging, which is available to all individuals, will help, but A will still pay more total income tax than B.

Corporations, on the other hand, are not eligible for the five year block averaging, even though the chief source of income is fishing. But this may be insignificant because corporations are not normally subject to progressive income tax. Corporations normally pay the same proportion to each dollar in tax, except where the corporation receives active business income in excess of the amount eligible for the small business deduction or has lost the small business deduction because too much earnings have been accumulated in the corporation.

(5) Instalment Income Tax Payments

Individuals whose chief source of income is fishing are required to make two payments to the income tax authorities. The first payment is to be made on 31 December and is equal to either (a) two thirds of the estimated tax payable for the year or (b) two thirds of the tax payable for the immediately preceding year, unless the tax payable under either alternative is not more than $400. Any remaining tax liability is supposed to be made by 30 April of the following year.

All corporations, on the other hand, are subject to a different set of rules. Corporations are required to make monthly payments on the last day of the month equal to either

(a) one twelfth of the amount estimated to be the tax payable for the year, or

(b) one twelfth of the tax payable for the immediately preceding year, or

(c) for the first two monthly payments, one twelfth of the tax payable for the second preceding year, and for the last ten monthly payments, one tenth of the amount remaining after deducting the first two monthly payments from the tax payable for the immediately preceding year.

(It will be noted that if method (b) were chosen, no monthly instalments would be required by the corporation in the first year of business because the tax payable for the immediately preceding year is zero.)

For corporations not eligible for the small business deduction, any remaining tax liability is supposed to be made by the end of the second month following the fiscal year end of the corporation. However, corporations eligible for the small business deduction do not need to make payment of any remaining tax liability until the end of the third month after the fiscal year end of the corporation.

(6) Registered Fishing Boat Savings Plan

The present Liberal government has announced in the April 1980 Throne Speech a proposed registered fishing boat savings plan. It was envisaged that the plans would permit a fisherman to contribute tax deductible amounts to the plan and, so long as the proceeds of the plan were used to purchase a fishing boat, the proceeds would not be taxable. It is unclear whether an incorporated fishing business would be able to make similar tax deductible contributions or whether the plans only apply to unincorporated fishing businesses. In any event, the registered fishing boat savings plan was conspicuously absent from Mr. MacEachen's Mini-Budget of May 1980. Consequently, only time will tell whether or not the registered fishing boat savings plan will be a relevant consideration.

3.04 Tax Shelter Alternatives

(1) Introduction

Many taxpayers do not incorporate their businesses to reduce or defer income tax. Many turn to other forms of tax shelter. In this section of the report, some of the more pertinent available tax shelters are outlined briefly, but before making a decision on a particular shelter, one must contact the person selling the shelter and consider carefully whether or not the shelter is appropriate in terms of the potential benefits. And tax shelters, while ultimately considered in terms of the tax benefits, must also be considered more appropriately in terms of the safety of the investment and the potential returns from it.

(2) Registered Home Ownership Savings Plans

Where neither the taxpayer or the taxpayer's spouse owns real estate, the taxpayer is entitled to make ten $1,000 a year payments into a registered home ownership savings plan for him or his spouse over a twenty-year period, and deduct these payments in calculating income tax. And, so long as the proceeds are used to purchase an owner-occupied home, the proceeds are not taxable.

(3) Registered Retirement Savings Plan

If a person is not contributing to a registered pension plan, the person can contribute the lower of 20 percent of earned income and $5,500 a year to registered retirement savings plans for him and his spouse. Where contributions are also made to a registered pension plan, the limit is the lesser of 20 percent of earned income and $3,500, less the amount of contributions to the registered pension plan. These contributions are deductible in computing income tax. Amounts received out of the registered retirement savings plans are taxable when received, so tax is deferred until amounts are received out of the plans. And if the amounts are received when income is lower than when the contributions were made, income tax is saved.

(4) High Risk Investments

There are three other types of tax shelter which provide generous income tax deductions, particularly in the early years. These are the multiple unit residential buildings, oil and gas partnerships, and films. Although investments in such things provide tax benefits, a person must be extremely careful in weighing the risks of losing your investment against the benefits. And the risks and benefits can differ between individual investments, so much so that an analysis cannot be made here. As a matter of fact, professional advice is normally warranted for someone not in the businesses.

4.00 GOVERNMENT REGULATION FEATURES

4.00 Government Regulation Features

4.01 Introduction

The topics covered in this part of the report may appear a little unrelated, but they generally fall within the overall category of government regulation. This part in essence analyses and discusses the impact, if any, of incorporation of a fishing business under various government programs. Unemployment insurance is discussed in section 4.02 and Workers' Compensation is discussed in section 4.03. Government licencing is discussed in 4.04 and government loan, grant and guarantee programs are discussed in section 4.05.

The factors discussed in this part, however, should not be taken alone; the overall situation must be considered, which means that features discussed in other parts of the report must be weighed, together with the features discussed in this part of the report. To accept a factor discussed in this part as the reason for or against incorporation could well be an error, with serious consequences.

4.02 Unemployment Insurance

Self-employed fishermen who are engaged in fishing on a share basis are not, strictly speaking, employees. However, under the unemployment insurance legislation, the buyer of the catch is considered the "employer" and the self-employed fishermen are considered "employees". And the buyer is responsible for paying the employer's unemployment insurance premium and deducting from the proceeds of the catch paid to the fishermen the employee's premiums, providing the required declaration is made to the buyer. Normally in this situation, the earnings of the fishermen would be insurable employment. However, the fisherman's employment would not be insurable inter alia where the buyer was a corporation in which the fisherman and/or his spouse controlled more than 40 percent of the issued voting shares of the corporation. Therefore, in order to be insured under the unemployment insurance legislation, the buyer cannot be a corporation in which a fisherman and/or his spouse control more than 40 percent of the issued voting shares, and this is the problem addressed in this section of the report.

Let us first assume that we have three fishermen - A, the captain, and two crew members, B and C - together with a boat owned by the captain. And further assume that the sharing arrangement is one share for the boat and one share for each of A, B and C. Now, in this situation, if the catch was sold (using the proper declaration) to a processing

corporation, "P Corporation", in which neither A nor B nor C, together with their spouses, control more than 40 percent of the issued shares of P Corporation, the earnings of A, B and C would be insurable and P Corporation would be required to pay the employer's share of the premiums, as buyer.

Now, since the boat's share is not insurable anyway, it may be possible to incorporate a corporation, A Limited, and transfer the boat to A Limited. In such a case, using the example from the previous paragraph, the sharing arrangement would be one share for A Limited (for the boat) and one share each for A, B and C. So long as the sharing arrangement was properly declared to the independent buyer, P Corporation, P Corporation would have the same responsibilities as where the boat was owned by A personally. That is, P Corporation would be the buyer and would still pay the employer's premium for unemployment insurance.

Other more complicated arrangements are possible, but these would have to be analysed individually in order to determine whether or not the arrangement would comply with the legislation. But so long as the catch is sold to an independent buyer, there would appear to be many potentially successful arrangements under the unemployment insurance legislation which would make the fishermen's shares insurable employment.

On the other hand, if A, B and C became employees of A Limited, A Limited would be the buyer under the unemployment

insurance legislation, even though A Limited continued to sell the catch to P Corporation. A Limited would be responsible for paying the employer's unemployment insurance premium for B and C and deducting B and C's individual premium. But A's earnings would not be insurable because A would own more than 40 percent of the shares of A Limited.

It was previously mentioned in the discussion of Income Tax Features in section 3.02(4) that one could incorporate and pay a spouse a salary for work performed, which would be deductible for income tax purposes. However, incorporation will not make a spouse's salary insurable under the unemployment insurance legislation where the fisherman and/or his spouse control more than 40 percent of the issued voting shares of the corporation. In any event, there may be ways of arranging the unincorporated business's affairs in such a way as to be able to insure a spouse's earnings through criss-cross or sub-contracting, but that is beyond the scope of this project.

It may well turn out that unemployment insurance is an insignificant consideration to some fishermen anyway, or the benefits of other features of incorporation may outweigh the benefits from unemployment insurance. Unemployment insurance benefits may turn out to be insignificant where the fisherman is making substantial income anyway, because today when your income is in excess of approximately $22,600,

the fisherman may have to repay a portion of the unemployment insurance benefits received. In addition, for example, the income tax benefits from incorporation may be greater than the amount received in unemployment insurance benefits. If a fisherman could save $5,000 in income tax if incorporated, but would lose $2,000 in unemployment insurance benefits, the loss of unemployment insurance benefits would not be a great loss. This example is simplified, however, in that it only considers income tax and unemployment insurance features, and other features would also be relevant to the incorporation decision.

4.03 Workers' Compensation

At the present time, all assessments requiring payment to the Workers' Compensation Board by fishermen have been cancelled, but where there are three fishermen on a fishing boat, the fishermen are covered for Workers' Compensation. And incorporation of the fishing business would present no problems.

However, an amendment to the Workers' Compensation Act has been passed by the House of Assembly, but it has not been proclaimed and accordingly, is not in effect. The amendment when proclaimed provides coverage for all fishermen, and the buyer of the catch would be responsible for payment of the Workers' Compensation assessment. In the unincorporated fishing business, the buyer of the catch would ordinarily be the fish plant. In the incorporated fishing business, care must be taken to ensure that the incorporated fishing business does not become the buyer; otherwise, the incorporated fishing business, and not the fish plant, would become liable for payment of the Workers' Compensation assessment. The fishermen would still be covered for purposes of receiving benefits, but the incorporated fishing business, if it were deemed the buyer, would be liable for the assessment. The arrangement (discussed more fully in section 4.02 Unemployment Insurance) whereby A, the captain, incorporates A Limited and transfers the boat with licence to A Limited and then a partnership (between A, B, C and A Limited, with each having one share)

does the fishing and sells the catch to the independent fish plant, would probably place the liability for payment of the Workers' Compensation assessment on the fish plant.

4.04 Government Licencing

At present there are, in essence, three types of licence. The first is the individual fisherman's licence permitting the fisherman to be involved in the fishery. In considering incorporation of a fishing business, there would be no need to transfer this licence to the corporation. The second type of licence is the CFV licence, which permits a boat to be used in the fishery, and where this licence is held in the name of an individual and the individual wishes to incorporate his fishing business and transfer the CFV licence to the corporation, so long as the individual owns a majority of the issued voting shares of the corporation, the Department of Fisheries and Oceans advises that this transfer would be permitted. But because the Minister of Fisheries and Oceans has discretion in the transfer of licences, it would be advisable to get the licence transfer approved before incorporating the business. The third type of licence is the restricted licence, which covers fishing in such areas as lobster, crab and salmon, or using equipment such as bar seines and purse seines. The Department of Fisheries and Oceans advises that it would not permit the transfer of these restricted licences from an individual to a corporation, even though the individual held a majority of the issued voting shares. However, this policy in this area could change and a fisherman contemplating incorporation may wish to consider the following statement of the present

Minister of Fisheries and Oceans:

> "... and if they're not incorporated in some instances they miss out in some advantages."*

In any event, other types of business have the alternative of carrying on business in the corporate form, and it is difficult to ascertain why the fisherman should be prohibited from so doing. If there is some group that the government wishes to prohibit from owning licences, other techniques may be available to prohibit that particular group from any involvement in the corporation without prohibiting fishermen from using a corporation, which may provide benefits to the fishing business and consequently to the economy of the country as a whole.

*Mr. Romeo Leblanc in the 15 February 1980 edition of The Sou'Wester.

4.05 Assistance Programs

(1) Introduction

In this section of the report, we are not concerned with government assistance programs which are available equally to incorporated and unincorporated fishing businesses. For example, both incorporated and unincorporated fishing businesses are eligible for fisheries improvement loans and gasoline tax rebates, and accordingly, are beyond the scope of the report.

The primary concern in this section of the report is to single out those government assistance programs which differentiate between, or are not available to, either an incorporated fishing business or an unincorporated fishing business. For convenience, the discussion will be divided into federal government programs and provincial government programs which are relevant to fishing businesses.

(2) Federal Government

It is not inconceivable that a fisherman might think of a new product or process which could be particularly useful in the fishing industry, but requires assistance in order to design and test the product or process to a point where commercial development of the new product or process is feasible. The Industrial Research Assistance Program and the product and process development portions of the Enterprise Development Program provide grants to assist in the development of new

products and processes. However, in order to be eligible for such grants, the fishing business must be incorporated.

(3) Provincial Government

The Fishing Vessel Assistance Plan of the Fisheries Loan Board provides assistance to fishing businesses in the form of direct loans, loan guarantees and bounties or grants. The assistance under this program is available to both unincorporated and incorporated fishermen, but because there are some important distinctions, the matter is raised here. Each individual in a corporation must have obtained at least 75 percent of his income from the harvesting sector of the fishery in each of the last two fishing seasons and been a fulltime fisherman in each of the last two years. In addition, with respect to direct loans and loan guarantees, these become repayable immediately on transfer or assignment of any shares in the corporation. Furthermore, in the case of bounties on new fishing vessels, no bounty is payable if a member of the corporation has received a bounty in the past 8 years, which would be important in selecting investors in any corporation.

5.00 STATUS IN UNION

5.00 Status in Union

The effect of incorporation of a fishing business on the status of a fisherman in the Newfoundland Fishermen, Food and Allied Workers' Union was considered in connection with this study. However, advice was given to the effect that the incorporation of the fishing business would have no effect on the status of the fisherman within the union.

6.00 METHODS OF INCORPORATION FEATURES

6.00 Methods of Incorporation Features

6.01 Introduction

Incorporation under the laws of Newfoundland and federal incorporation are the subject of this part of the report. And the discussion will revolve around the major differences between provincial (Newfoundland) and federal incorporation. Again, in this discussion, the choice of provincial over federal incorporation depends on the circumstances of the fishing business in question. For example, if time is a factor, in that the corporation must be incorporated in a hurry, then provincial incorporation may be warranted, as it is usually quicker. But there are other features to be considered as well, and a full consideration of the differences between the two types of incorporation is warranted before a decision is made.

It must be pointed out that many of the differences between a federal and provincial corporation will disappear if the report entitled "Proposals For A New Company Law For Newfoundland" is adopted, but to date no legislation has been introduced in the House of Assembly.

6.02 Name of Corporation

It usually takes more time to have the name a person has selected for the corporation approved by the federal authorities than it does to have a name approved for a provincial corporation. However, if a person is in a rush, a number name such as 123456 Limited can be approved immediately while waiting for the real name to be approved.

It costs a minimum of $15 to have the name chosen for a federal corporation accepted. On the other hand, it costs nothing to have a name accepted provincially, but if it is desired to reserve a name provincially until ready for incorporation, the provincial fee is $10.

A provincial corporation must use the word "Limited" (or its abbreviation) as the last word in its name, whereas a federal corporation can alternatively use "Corporation" or "Incorporated" (or their abbreviations) as the last word.

6.03 Number of Shareholders

A federal corporation need only have one shareholder whereas a provincial corporation must have three shareholders. However, in practice in Newfoundland, one person frequently owns all the shares of a provincial corporation, but uses two other persons as nominal shareholders in order to meet the three shareholder requirement. The other two persons have no beneficial ownership in the corporation, but have a right to inspect certain records of the corporation and attend meetings.

6.04 Corporate Seal

A provincial corporation is required to have a corporate seal, which costs approximately $25. A federal corporation does not have to have a corporate seal.

6.05 Filing Fees

It costs a minimum of $115 to file the documents necessary for incorporation provincially. It costs $200 (plus the minimum name search fee of $15) to file the documents necessary for federal incorporation, together with a minimum additional fee of $32 to register the federal corporation to carry on business in Newfoundland.

The annual reporting fee for a provincial corporation is $25, while the annual reporting fee federally is $30. And where the federal corporation is carrying on business in Newfoundland, the federal corporation is required to file an annual report at an additional cost of $120.

6.06 Powers of Corporation

A federal corporation has the powers of a natural person, unless the powers are restricted in the incorporating documents. On the other hand, a provincial corporation only has the powers specified in its incorporating documents, but the practice is to give the provincial corporation as wide a power as a federal corporation.

Restrictions on the powers of a corporation can sometimes be advantageous. For example, it can give a limited amount of protection to the minority shareholder vis-a-vis a majority shareholder. Let us say the minority shareholder only wants the corporation to be involved in the fishing business. If the majority shareholder wants to expand into, for example, the shoe business, if there are no restrictions, in most cases the majority shareholder can do so. If, on the other hand, the power to go into other businesses is prohibited, the majority shareholder would not be able to go into the shoe business without court approval, which is not likely to be given against the wishes of the minority shareholder.

6.07 Buying Back Shares

A federal corporation can (so long as the capital of the corporation is not impaired) buy back the previously issued common shares, which may be appropriate when a shareholder wants to leave or where he dies. On the other hand, a provincial corporation, in order to buy back common shares, must go through a costly reduction of capital in order to do so. But one possible way around a costly reduction of capital is to have another person buy the shares.

6.08 Pre-Incorporation Contracts

Contracts entered into on behalf of a corporation to be formed are invalid if the corporation is a provincial one. Once the corporation is formed, a new contract must be entered into in order to be valid, which could be a problem where the price of an item being purchased by the corporation has gone up in the meantime.

Similar contracts entered into on behalf of a corporation to be formed federally are valid and can be ratified once the corporation is formed. There is no need federally to enter into a new contract.

6.09 Time

As mentioned in the introduction (section 6.01), it normally takes more time to incorporate a federal corporation, simply because of the distances to Ottawa. The time can also be lengthened because of the necessary name clearance, in the case of federal corporations.

6.10 Shareholder Protection

Minority shareholders have more protection in federal corporations than in provincial corporations. For example, where a majority shareholder violates the rights of the minority shareholder, the minority shareholder may have an action against the majority shareholder in a federal corporation, whereas he may have no action if he were a minority shareholder in a provincial corporation.

There are also greater protections to the shareholders against abusive practices by majority shareholders and directors in the federal corporation.

7.00 CONCLUSION

7.00 Conclusion

The title of this part of the report is a misnomer, in that a conclusion on whether or not to incorporate a fishing business can only be made after a complete consideration of all the features of incorporation discussed in the previous parts of the study. It also requires that the features discussed in the previous parts be related to the circumstances of the fishing business in question. And all features will possibly carry different weight with different fishing businesses.

In any event, there are perhaps some features of incorporation that deserve special mention and special consideration by the fisherman contemplating incorporation. One consideration is the potential loss of unemployment insurance. Another potential difficulty is the need to transfer the licence to operate the fishing boat to the corporation in order to be eligible for the income tax small business deduction. In addition, in the income tax area is the potential loss of the cash method of accounting, five year block averaging, income averaging annuities and deductibility of losses. Furthermore, on the negative side of things, is the requirement of keeping one set of records for the fisherman and another set of books for the corporation.

On the positive side, there may be some advantages to incorporation from limited liability. And in the income tax area, there may be advantages from the small business deduction, deferred profit sharing plans, salary for a spouse and tax-free rollovers to children, grandchildren and great-grandchildren of $200,000 in capital gains. But in order to

avail the fishing business of most of the income tax benefits, it will probably be necessary to transfer the fishing boat and licence to the corporation. If this is feasible, it may be that the advantages of incorporation could outweigh the disadvantages. Or it could also be that the disadvantages outweigh the advantages.

In any event, it is crucial that the person contemplating the incorporation of a fishing business consider and weigh all the features discussed in all parts of this report. And it would also be prudent for the person to consult with professional advisers who should be able to provide advice based on the individual circumstances of each fishing business. The individual circumstances of each fishing business will determine whether or not incorporation is feasible. And not all fishing businesses are the same. Consequently, the fisherman contemplating incorporation should personally consider, together with his advisers, all the features discussed in this report.